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In the Supreme Court of the United States

OCTOBER TERM, 1934

No. 127

EVELYN F. GREGORY, PETITIONER

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT

OPINIONS BELOW

The opinion of the United States Board of Tax Appeals (R. 8–11) is reported in 27 B. T. A. 223. The opinion of the Circuit Court of Appeals (R. 33–37) is reported in 69 F. (2d) 809.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered March 26, 1934. (R. 37–38.) The petition for a writ of certiorari was filed June 23, 1934, and was granted October 8, 1934. (R. 39.) The

jurisdiction of this Court rests on Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Where the sole stockholder of a corporation, actuated solely by a desire to sell and receive the proceeds of certain surplus assets of the corporation with payment of the least possible tax, causes a new corporation to be organized and the assets to be transferred to it in return for the issuance of all of its stock to said stockholder, and immediately following the transfer the new corporation is dissolved and the assets are distributed to the stockholder, does such transaction come within the reorganization provisions of the Revenue Act of 1928, so that the stockholder is taxable only on the basis of profit realized by her upon the liquidation of the new company or does it amount to payment of a taxable dividend by the original corporation?

STATUTES AND REGULATIONS INVOLVED

These are set forth in the Appendix, *infra*, pp. 34–40.

STATEMENT

The following material facts are taken from the opinion of the Board of Tax Appeals (R. 8–9) as supplemented by a statement of the petitioner's attorney made before the Board of Tax Appeals (R. 18–20) and the evidence at the hearing (R. 26–30):

The petitioner was the owner of 5,000 shares of the United Mortgage Corporation, constituting all of its outstanding stock. Of these, 3,300 shares had been purchased between October 1, 1920, and December 16, 1921, at a cost of $180,000, and 1,700 shares between January 12, 1927, and January 3, 1928, at a cost of $170,000. The United Mortgage Corporation had among its assets 1,000 shares of the Monitor Securities Corporation (R. 13, 18), which represented a part of the surplus of the United Mortgage Corporation, and which cost it $10,413.07 when purchased in 1922 (R. 22, 25).

"In 1928 certain bankers began negotiations for the purchase of all of the stock of the Monitor Securities Corporation * * *. It became evident that, if the United Mortgage Corporation sold the stock, double taxation would accrue; that is, a tax to the corporation and a tax to Mrs. Gregory on the distribution to her as a stockholder, as a dividend. She, in conference with attorneys, frankly sought a way to avoid the payment of a double tax." (R. 18.)

A plan was devised by petitioner to transfer the Monitor stock to a new corporation and then dissolve the new corporation and deliver the Monitor stock to the taxpayer and let her sell it.

In pursuance of this plan, the Averill Corporation was organized under Delaware law on September 18, 1928, by petitioner (R. 9.) On or about September 21, 1928, the United Mortgage Corpora-

tion transferred to the Averill Corporation the 1,000 shares of Monitor stock and the Averill Corporation issued all of its capital stock to the petitioner. (R. 19, 25.) Averill Corporation "thereafter immediately" on the same day began proceedings for its dissolution, which were concluded September 24, 1928. On that date the Averill Corporation liquidated and dissolved and distributed to the petitioner the 1,000 shares of Monitor stock constituting all of its assets. "Immediately thereafter" on the same date as the distribution, the petitioner sold the Monitor shares for $133,333.33. The distribution of the 1,000 shares of Monitor stock to petitioner "occurred *at the same time* as the sale of said stock by her." (R. 19; italics ours.)

The value of the Monitor stock on the date of distribution to and sale by the petitioner was $133,333.33. The Averill Corporation transacted no business. It was never contemplated it should transact any business. It had no books of account, "none being deemed necessary" (R. 24), as it was not to do any business, but to be immediately dissolved upon receiving the Monitor stock. The sole purpose of its organization was to enable the petitioner to save income taxes which she might otherwise be required to pay, if she carried through the transaction individually. (R. 18, 29.)

"The entire transaction in the formation of Averill and its dissolution was carried out and supervised by counsel for Mrs. Gregory and on their advice." (R. 29.)

In her return for the calendar year 1928 the petitioner treated the several transactions as governed by the reorganization provisions of the Revenue Act of 1928, and returned as capital net gain from the sale price of $133,333.33 the amount of $76,007.88 upon an apportioned cost basis of $57,325.45. (R. 23.)

The Commissioner of Internal Revenue determined a deficiency of $10,678.16 by including the value of the Monitor stock, or $133,333.33, in the petitioner's income as an ordinary dividend subject to surtax and eliminating from income the capital gain of $76,007.88 theretofore reported by the petitioner. (R. 20.) On appeal the Board of Tax Appeals held that the petitioner realized a taxable gain of $76,007.88 on liquidation of the Averill Corporation measured by the difference between $133,333.33, the value of the Monitor Securities Corporation stock, and $57,325.45, the cost attributed to the stock of the Averill Corporation in the petitioner's hands. (R. 11.) The Circuit Court of Appeals, reversing the Board, held that the transfer of the Averill Corporation stock to the petitioner in consideration of the receipt of the Monitor Securities Corporation stock from the United Mortgage Corporation was not made pursuant to a plan of reorganization within the meaning of Section 112 (g) and (i) of the Revenue Act of 1928 and that the value of the Averill Corporation stock received by the petitioner was taxable in her hands as a dividend. (R. 33, 37.) The resulting defici-

ency under the decision of the Circuit Court of Appeals is the same in amount as that determined by the Commissioner.

SUMMARY OF ARGUMENT

If Section 112 (g) and (i) were not a part of the Revenue Act of 1928 the petitioner would be taxable upon the value of the Averill Corporation stock as a dividend. Since the petitioner claims a present exemption or an exception to the usual mode of taxation, she must bring herself squarely within the statutory provisions. When the statutory words are considered in the light of the legislative purpose it will be seen that the petitioner's case is not included. An examination of the legislative history of the reorganization provisions clearly indicates that Congress intended to afford a present exemption only where a corporate readjustment is made for an ordinary business purpose having some relation to the continuation of a business enterprise. In construing the provisions the courts have observed this underlying idea. There are persuasive reasons for applying to the reorganization provisions the principle that the literal language of the statute is to be interpreted in the light of the purposes intended to be accomplished. If this should not be done the purpose of the legislature would be defeated to an appreciable extent. In other cases the courts have narrowed the language of these provisions by reference to their purpose.

So interpreted it is plain that the petitioner's situation is not embraced within the provisions upon which she relies. The Averill stock was not distributed pursuant to a plan of reorganization, since there existed no purpose germane to the business. Accordingly the Averill stock was taxable to petitioner as a dividend.

Congress has evidenced a clear intent to tax all distributions such as that here, made by a corporation from its earnings or profits accumulated since February 28, 1913. Looking at the substance of the transaction it is apparent that the Averill Corporation was a mere device or instrumentality controlled by the petitioner and formed for one purpose only—to distribute earnings of the United Mortage Corporation to petitioner free from the tax intended to be imposed. In such a situation it is proper to look through the agency used and to determine the case upon the real substance of the transaction. This Court and other courts have so held. Applying this principle, it must follow that the Monitor stock was distributed as a dividend to the petitioner through the instrumentality of the Averill Corporation and its value was taxable to her as a dividend.

ARGUMENT

I

THE DISTRIBUTION OF THE AVERILL CORPORATION STOCK TO THE PETITIONER WAS NOT MADE PURSUANT TO A PLAN OF REORGANIZATION WITHIN THE MEANING OF SECTION 112 (G) OF THE REVENUE ACT OF 1928, AND THE VALUE OF THE STOCK SO RECEIVED WAS TAXABLE TO THE PETITIONER AS AN ORDINARY DIVIDEND

In the absence of the provisions of Section 112 (g) and (i) of the Revenue Act of 1928 (*infra*, p. 35), there could be no doubt but that the petitioner would be held to have been the recipient of a taxable dividend as a result of the distribution of the Averill Corporation stock. This Court has held under taxing statutes containing no such exemption provisions that such distributions constitute taxable dividends (*United States* v. *Phellis*, 257 U. S. 156; *Rockefeller* v. *United States*, 257 U. S. 176), and Sections 22 (a) and 115 (a) and (b) of the Revenue Act of 1928 (*infra*, pp. 34, 37) include in a stockholder's income distributions made from corporate earnings accumulated after February 28, 1913. By including in the petitioner's taxable income as a dividend the value of the Monitor stock, or $133,333.33, the Commissioner determined that the earnings of the United Mortgage Corporation since February 28, 1913, were at least this amount.

The Monitor stock was purchased by the United in 1922 for $10,413.07 and it was carried on the books of the United at this price. (R. 25.) Referring to the transfer of the Monitor stock on

September 21, 1928, the record discloses a stipulation that:

"On the books of United Mortgage Corp., the transaction was entered as a charge to surplus for $10,413.07 and a credit to the investment asset account 'Monitor Securities Corporation' stock for $10,413.07, which closed out the latter account. The surplus affected was accumulated after February 28, 1913." (R. 25–26.)

At that time the United Mortgage Corporation had assets of $814,064.25, which included the Monitor stock of the value of $133,333.33. It had 5,000 shares of capital stock, which cost petitioner $350,000.00. (R. 23.)

The petitioner contends that her situation comes within the literal language of Section 112 (g) and (i) of the Revenue Act of 1928 and that accordingly she did not receive a taxable dividend. We submit that the court below properly held that these subsections, properly interpreted, do not embrace her case.

Section 112 (g), *infra,* provides that "If there is distributed, in pursuance of a plan of reorganization, to a shareholder in a corporation a party to the reorganization, stock or securities in such corporation or in another corporation a party to the reorganization, without the surrender by such shareholder of stock or securities in such a corporation, no gain to the distributee from the receipt of such stock or securities shall be recognized." A "reorganization" is defined in Section

112 (i) (1) (B) to mean "a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its stockholders or both are in control of the corporation to which the assets are transferred."

Since in the absence of these provisions the petitioner would undoubtedly be compelled to pay a tax on the whole amount of the dividend, it is apparent that she is claiming an exemption or an exception to the usual mode of taxation. A taxpayer who claims an exemption must bring himself squarely within the statutory terms and the rule is equally applicable to a taxpayer who claims the benefit of exceptional treatment. *Bowers* v. *Lawyers Mortgage Co.*, 285 U. S. 182, 187. Where a provision grants an exemption from the full rate of taxation doubts must be resolved against the taxpayer. *Heiner* v. *Colonial Trust Co.*, 275 U. S. 232, 235.

It was incumbent upon the petitioner to show that the transaction constituted a "reorganization" within the meaning of the Act, that she received stock from a party to the reorganization, and that this distribution was made "in pursuance of a plan of reorganization." She contends that her case conforms with the literal language of the statute, regarding as immaterial the fact that the conformance was at most transitory; that the purpose of her plan was merely to effect the distribution of a single corporate asset to her as sole stockholder free from a tax on dividends; and that there

was no intention to carry on the business through a changed corporate structure. We contend that when the words of the statute are considered in the light of its obvious purpose, it will be demonstrated that the petitioner's case is not included.

An examination of the legislative history of the so-called reorganization provisions of the Revenue Acts demonstrates that they were intended to exempt only those ordinary business transactions where, on a readjustment of corporate enterprises, a continuing interest is held in the business. The Revenue Act of 1918 (c. 18, 40 Stat. 1057), Section 202 (b), contained the first enactment in this respect. It provided that no gain or loss should be recognized where, in connection with a reorganization, a person received in place of stock or securities owned by him, new stock or securities of no greater par value. As the Senate Finance Committee's report shows, the provision was inserted to free purely paper gains from tax. S. Rep. No. 617, 65th Cong., 3d Sess., p. 5. The Revenue Act of 1921 (c. 136, 42 Stat. 227), in Section 202 (c) (2), incorporated a definition of the word "reorganization" and provided that no gain or loss should be recognized, whether or not the new stock or securities received were of a greater par value. In discussing the amendments the House Ways and Means Committee stated, in part (H. Rep. No. 350, 67th Cong., 1st Sess., p. 10):

> The preceding amendments, if adopted, will, by removing a source of grave uncer-

> tainty, not only permit business to go forward with the readjustments required by existing conditions but will also considerably increase the revenue by preventing taxpayers from taking colorable losses in wash sales and other fictitious exchanges.

Similar language is contained in the report of the Senate Finance Committee. See S. Rep. No. 275, 67th Cong., 1st Sess., pp. 11–12.

The Revenue Act of 1924 was the first Act which contained a provision similar to Section 112 (g) of the Revenue Act of 1928, upon which the petitioner relies. See Section 203 (c), Revenue Act of 1924, c. 234, 43 Stat. 253, 256 (U. S. C., Title 26, Sec. 934). In discussing certain additional exemptions on reorganization added in that Act, the Ways and Means Committee of the House said (H. Rep. No. 179, 68th Cong., 1st Sess., p. 13):

> Congress has heretofore adopted the policy of exempting from tax the gain from exchanges made in connection with a reorganization *in order that ordinary business transactions will not be prevented on account of the provisions of the tax law.* If it is necessary for this reason to exempt from tax the gain realized by the stockholders, it is even more necessary to exempt from tax the gain realized by the corporation. (Italics ours.)

The reorganization provisions of the Revenue Act of 1924 have been reenacted in substantially

the same form under the Revenue Act of 1926, Section 203 (c. 27, 44 Stat. 9, 12; U. S. C. App., Title 26, Sec. 934), and the Revenue Act of 1928, Section 112, *infra,* p. 35, and the committee reports under the latter Acts throw no further light upon the legislative purpose. We submit that the history of these provisions clearly indicates that Congress intended to afford a present exemption only where the corporate readjustment is made for an ordinary business purpose having some relation to the continuation of a business enterprise, with a change purely formal in nature. The court below aptly stated this purpose in its opinion as follows (R. 35):

> But the underlying presupposition is plain that the readjustment shall be undertaken for reasons germane to the conduct of the venture in hand, not as an ephemeral incident, egregious to its prosecution. To dodge the shareholders' taxes is not one of the transactions contemplated as corporate "reorganizations."

In construing the reorganization provisions the courts have observed the underlying idea that they were intended to facilitate the continuation of a corporate business where the change was one in form only, by exempting such readjustments from tax at the time they were made. In *Lonsdale* v. *Commissioner,* 32 F. (2d) 537 (C. C. A. 8th), certiorari denied, 280 U. S. 575, in considering the

provisions of the Revenue Act of 1924, the court said (p. 539):

> This section obviously has reference either to a complete reorganization of the original corporation by a transfer of its entire assets to another, then existing or newly organized, or to a transfer of a part of the assets in such manner that the corporations may thereafter be under one control and may be operated substantially as one in the prosecution of their business. It cannot properly, and does not, we think, refer to the organization of an independent company—although with substantially the same stockholders and officers—which is authorized by its charter to transact business and engage in dealings which are prohibited to the original corporation. * * *

In *Prairie Oil & Gas Co.* v. *Motter,* 66 F. (2d) 309 (C. C. A. 10th), the court used the following language (pp. 310–311):

> Reading all the sections exempting from tax transfers made to accomplish reorganizations, the congressional intent is plain. Where a merger or consolidation takes place, and the stockholders retain their interest in the corporate properties, there is no realized gain; there is but a substitution of their certificates of participation. Such transfers were exempted from tax so that such reorganizations should not needlessly be impeded. * * *

In another case, *Cortland Specialty Co.* v. *Commissioner,* 60 F. (2d) 937, certiorari denied, 288

U. S. 599, which involved a claim of corporate reorganization, the court below discussed the purpose of the statute as follows [1] (p. 940):

> Its purpose was to relieve those interested in corporations from profits taxes in cases where there was only a change in the corporate form in which business was conducted without an actual realization of any gain from an exchange of properties. When describing the kind of change in corporate structure that permits exemption from these taxes, section 203 does not disregard the necessity of continuity of interests under modified corporate forms. * * *. In defining "reorganization", section 203 of the Revenue Act gives the widest room for all kinds of changes in corporate structure, but does not abandon the primary requisite that there must be some continuity of interest on the part of the transferor corporation or its stockholders in order to secure exemption. Reorganization presupposes continuance of business under modified corporate forms.

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[1] The word "reorganization", as it is commonly used, connotes the idea of a continuity of interests in a business under modified or changed corporate form. See Fletcher, Cyclopedia Corporations—Permanent Edition (1932), Vol. 15, pp. 268–271. We do not imply that the word "reorganization" as it is used in the statute is necessarily limited to a definition gathered from other sources. But the nature of a reorganization as it is commonly understood is, we believe, important in determining the legislative intent where the statutory language does not conflict with the general commercial understanding.

We submit that the literal language of the statute must be considered and construed in the light of the purposes intended to be accomplished. This Court has declared that in construing a statute it is not always confined to a literal reading and may consider its object and purpose, the things with which it is dealing, and the condition of affairs which led to its enactment, so as to effectuate, rather than destroy, the spirit and force of the law which the legislators intended to enact. *American Tobacco Co.* v. *Werckmeister*, 207 U. S. 284, 293. The intention of the law-making power will prevail even against the letter of the statute. *Fleischmann Co.* v. *United States*, 270 U. S. 349, 360; *Hawaii* v. *Mankichi*, 190 U. S. 197, 212; *Petri* v. *Commercial Bank*, 142 U. S. 644, 650. In *Holy Trinity Church* v. *United States*, 143 U. S. 457, an alien, pursuant to a contract, came to the United States and entered into the service of the church as rector. The Circuit Court ~~of Appeals~~ held that the act of the church in inducing the alien to enter the country came within the language of an Act of Congress providing that it should be unlawful to assist or encourage in any way the importation or migration of any alien "to perform labor or service of any kind in the United States." While conceding that the act of the church came within the letter of the statute, this Court held that it was not within the legislative intent and reversed the Circuit Court ~~of Appeals~~, saying in part (p. 459):

> It is a familiar rule, that a thing may be within the letter of the statute and yet not within the statute, because not within its spirit, nor within the intention of its makers. This has been often asserted, and the reports are full of cases illustrating its application. This is not the substitution of the will of the judge for that of the legislator, for frequently words of general meaning are used in a statute, words broad enough to include an act in question, and yet a consideration of the whole legislation, or of the circumstances surrounding its enactment, or of the absurd results which follow from giving such broad meaning to the words, makes it unreasonable to believe that the legislator intended to include the particular act. * * *

In the recent case of *Helvering* v. *N. Y. Trust Co.*, 292 U. S. 455, this Court considered Section 206 (a) (6) of the Revenue Act of 1921, defining "capital assets" to be "property acquired and held by the taxpayer for profit or investment for more than two years". This Court conceded that if the words alone should be looked to, the trustee's situation did not meet the definition, since it was a taxpayer and had held the stock less than two years prior to its sale. But in construing the definition in the light of the legislative history and of other provisions of the Act, a majority of the Court held that the period during which the trustor held the property should be added to the trustee's holding

period, thus bringing the situation within the definition. The opinion states in part (pp. 464–465):

> The rule that where the statute contains no ambiguity, it must be taken literally and given effect according to its language is a sound one not to be put aside to avoid hardships that may sometimes result from giving effect to the legislative purpose. *Commissioner of Immigration* v. *Gottlieb*, 265 U. S. 310, 313. *Bate Refrigerating Co.* v. *Sulzberger*, 157 U. S. 1, 37. But the expounding of a statutory provision strictly according to the letter without regard to other parts of the Act and legislative history would often defeat the object intended to be accomplished. Speaking through Chief Justice Taney in *Brown* v. *Duchesne*, 19 How. 183, this court said (p. 194): "It is well settled that, in interpreting a statute, the court will not look merely to a particular clause in which general words may be used, but will take in connection with it the whole statute (or statutes on the same subject) and the objects and policy of the law, as indicated by its various provisions, and give to it such a construction as will carry into execution the will of the Legislature, as thus ascertained, according to its true intent and meaning." Quite recently in *Ozawa* v. *United States*, 260 U. S. 178, we said (p. 194): "It is the duty of this Court to give effect to the intent of Congress. Primarily this intent is ascertained by giving the words their natural significance, but if this leads to an unreasonable result plainly at variance with the policy

> of the legislation as a whole, we must examine the matter further. We may then look to the reason of the enactment and inquire into its antecedent history and give it effect in accordance with its design and purpose, sacrificing, if necessary, the literal meaning in order that the purpose may not fail." And in *Barrett* v. *Van Pelt,* 268 U. S. 85, 90, we applied the rule laid down in *People* v. *Utica Ins. Co.,* 15 Johns. 358, 381, that "a thing which is within the intention of the makers of a statute is as much within the statute as if it were within the letter, and a thing which is within the letter of the statute, is not within the statute, unless it is within the intention of the makers."

There are persuasive reasons for applying these principles to the reorganization provisions of the Revenue Acts. In enacting a vast and intricate scheme of taxation there are necessarily many complications unsuspected by the framers of the statute. It is too much to expect that the words of the Act can definitely circumscribe the bounds of every business plan; in many cases they can merely express the general intention of the law-making body. "Generally, questions as to the meaning intended do not arise until the language used is compared with the facts or transactions in respect of which the intent and purpose are to be ascertained." *Helvering* v. *N. Y. Trust Co., supra,* p. 465. It is obvious that the reorganization provisions were enacted for a definite and limited purpose. They

are equitable in nature and are designed for the relief or encouragement of those who, in a *bona fide* readjustment of corporate enterprises, receive stock or securities which, though normally taxable, represent no real gain to the recipient but merely evidence continued participation in a revised business structure. To permit their benefits to be obtained by those who have no such plan in view but who are merely making temporary use of a new corporation to place themselves within the literal language of the statute, would defeat to an appreciable extent the intention of the framers of the Act.

As the court below observed (R. 36) the language of the reorganization statutes has been narrowed by reference to the purposes of their enactment in other cases. In *Pinellas Ice & Cold Storage Co.* v. *Commissioner,* 287 U. S. 462, the claimed reorganization came within the literal words of Section 203 (h) (1) (A) of the Revenue Act of 1926, since one corporation had acquired all the property of the other. This Court agreed with the court below that this was not a "reorganization", basing its conclusion upon the ground that it was beyond the evident purpose of the statute to include a plan of action where a seller of property acquired no more definite interest in the affairs of the purchasing company than that incident to ownership of its short-term purchase-money notes. A decision of similar effect was rendered by the Circuit Court of Appeals for the Second Circuit in *Cortland Specialty Co.* v. *Commissioner, supra.* To the same effect is the

decision of the Circuit Court of Appeals for the Tenth Circuit in *Prairie Oil & Gas Co.* v. *Motter, supra,* where the Collector was contending for a literal interpretation of the Act. The court refused to adopt the literal interpretation and sought out the Congressional intent.[2]

The facts of this case indicate clearly that there was no "reorganization" or "plan of reorganization" within the meaning of the words of the statute when interpreted in the light of the legislative intent. Shortly before the various transfers were made certain bankers had begun negotiations for the purchase of the Monitor stock and it is admitted that the whole transaction was undertaken only for the purpose of reducing in the best possible way the taxes which would result from the sale of this stock and the distribution of the proceeds to the petitioner, the sole stockholder of the United Mortgage Corporation. (R. 19, 29.) In pursuance of this objective, the Averill Corporation was formed on September 18, 1928. On September 21, 1928, the United Mortgage Corporation transferred the Monitor stock to the Averill Corporation and at

[2] In certain recent decisions the Board of Tax Appeals has also declined to follow the strict literal language. See *Minnesota Tea Co.* v. *Commissioner*, 28 B. T. A. 591; *John J. Watts* v. *Commissioner*, 28 B. T. A. 1056; *Central National Bank of Lincoln, Nebraska*, v. *Commissioner*, 29 B. T. A. 719; *A. L. Miller* v. *Commissioner*, 29 B. T. A. 1061; and see *The Ballwood Co.* v. *Commissioner*, 30 B. T. A. 644, in which the Board relied to some extent upon the decision of the court below in the instant case.

the same time the Averill Corporation issued all of its stock to the petitioner, and immediately began proceedings for dissolution, which were concluded on September 24, 1928; and it then distributed the Monitor shares to the petitioner and immediately thereafter the petitioner sold the stock. (R. 19.)

The transfer was not a reorganization and the Averill shares were not distributed in pursuance of a plan of reorganization.

In commenting on this aspect of the case the court below said: "The purpose of the section is plain enough; men engaged in enterprises—industrial, commercial, financial, or any other—might wish to consolidate, or divide, to add to, or subtract from, their holdings. Such transactions were not to be considered as 'realizing' any profit, because the collective interests still remained in solution." The court stated that it was plain that the readjustment must be undertaken for reasons germane to the conduct of the venture in hand, and that to dodge the shareholders' taxes was not one of the transactions contemplated as corporate "reorganizations." (R. 35.)

The court further said the steps taken "were not what the statute means by a 'reorganization', because the transactions were no part of the conduct of the business of either or both companies; so viewed they were a sham, though all the proceedings had their usual effect." (R. 37.)

"Reorganization presupposes continuance of business under modified corporate forms." *Cortland Specialty Co.* v. *Commissioner, supra,* p. 940, cited with approval by this Court in *Pinellas Ice & Cold Storage Co.* v. *Commissioner, supra.*

It was never contemplated that the Averill Corporation should do any business, but on the contrary it was formed for the sole purpose of being dissolved just as soon as the Monitor stock should be transferred to it so that petitioner could get the stock and sell it as agreed upon, before it was organized. This plan was carried out literally and while the Averill charter was obtained a few days before the Monitor stock was transferred, yet just as soon as the Averill Corporation got this stock, or, in the language of the record, "thereafter immediately" (R. 19) it began proceedings for its dissolution. So the Averill Corporation was a going concern only for an instant of time. Under these admitted facts, we do not see how the Board of Tax Appeals could be of the opinion that this was a "bona fide use of the corporate device" in a plan of reorganization prescribed by statute.

Instead of being a plan of reorganization it was simply a plan to use the new corporation as a means of getting the Monitor stock in the hands of the petitioner so that she could sell it. "It is not disputed," said the court below, "that all these steps were part of one purpose to reduce taxes, and that the Averill Corporation, which was in existence for only a few days, conducted no business and was

intended to conduct none, except to act as conduit for the Monitor shares in the way we have described." (R. 34.)

All the steps taken were in pursuance of a plan devised by the attorneys for the petitioner, not for the purpose of effecting a reorganization, but admittedly for the sole purpose of avoiding payment of income taxes. "The entire transaction in the formation of Averill and its dissolution was carried out and supervised by counsel for Mrs. Gregory and on their advice." (R. 29.)

When the plan had been carried out, a few days after the transaction was begun, the United Mortgage Corporation continued as before to be the only corporation in existence, the petitioner continued to hold all its shares and the business enterprise remained unaffected, except that an asset had been transferred from corporate surplus to the petitioner for the purpose of sale by her. Manifestly there was no continuation of the business enterprise merely in changed corporate form. It is apparent that the whole transaction was undertaken, not for any purpose germane to the business, but solely to avoid taxes upon the disposition of an asset. A provision extending relief to transfers which are incidental to a formal change in the corporate structure of a business, undertaken for business reasons, cannot apply to a case such as this where the transfer was merely incidental to and part of a distribution of a portion of the accrued profits of a business to its sole stockholder.

Moreover, in order to be free from tax under Section 112 (g) of the 1928 Act the distribution must be made "in pursuance of a plan of reorganization". The plan here was not one for the reorganization of a business enterprise; it had as its sole purpose the payment of a dividend free from tax. It was not a plan of reorganization at all, but a plan for distribution and sale of a corporate asset with the least possible resulting tax. It did not contemplate that the Averill Corporation should continue to exist and operate as part of a revised corporate structure. That corporation was to act only as a temporary agency in making the complete transfer. The transfer of assets to the new agency and the immediate dissolution of that agency were but integral parts of the single preconceived plan for distributing the Monitor stock to the petitioner as her separate property for the purpose of immediate sale. All the steps of the plan must be considered in determining whether it is a "plan of reorganization". *Prairie Oil & Gas Co.* v. *Motter, supra; West Texas Refining & D. Co.* v. *Commissioner,* 68 F. (2d) 77 (C. C. A. 10th). When so considered in this case it is evident that the distribution was not pursuant to a plan of reorganization within the meaning of Section 112 (g) of the Act and the petitioner is taxable, as the court below held, upon the value of the Averill Corporation stock as a dividend.

While this was not the theory of the Commissioner in determining the tax the result is the same,

since the value of the Averill Corporation stock was the same as the value of the corporation's sole asset, namely, the stock of the Monitor Corporation. The correct amount of the deficiency is the controlling factor and not the method by which it was determined. *Hughes* v. *Commissioner,* 38 F. (2d) 755, 757 (C. C. A. 10th); *Hurwitz* v. *Commissioner,* 45 F. (2d) 780 (C. C. A. 2d). We submit that the court below was correct in holding that the deficiency determined by the Commissioner should be sustained.

II

IN SUBSTANCE THERE WAS A DISTRIBUTION OF THE MONITOR SECURITIES CORPORATION STOCK THROUGH THE AGENCY OF THE AVERILL CORPORATION AND THE VALUE OF THE STOCK SO RECEIVED REPRESENTED A TAXABLE DIVIDEND TO THE PETITIONER

Congress has evidenced a clear intention to tax a stockholder upon all distributions made from earnings or profits of a corporation accumulated since February 28, 1913. It has so provided in Section 115 (a) of the Revenue Act of 1928 (*infra,* p. 37). To make doubly sure that the intended tax will result it has provided in Section 115 (b) of the same Act, *infra,* that for the purpose of the tax every distribution is made out of earnings or profits to the extent thereof and from the most recently accumulated earnings or profits. And Section 115 (g) of the Act was enacted to tax any amount distributed by a cancellation or redemption of stock when it was essentially equivalent to the distribution of a taxable dividend. As stated heretofore,

the value of the Monitor stock must be held to constitute earnings or profits of the United Mortgage Corporation since the petitioner failed to show that the surplus profits of the corporation were less than $133,333.33, the value of the stock at the time of distribution.

It is quite evident that the sole purpose of the formation of the Averill Corporation was to distribute the Monitor stock to the petitioner without incurring the stockholder's tax on the distribution. The Averill Corporation was formed, it received and distributed the stock and then vanished from the scene by dissolution, all within not more than six days. In substance the transaction was a distribution to the petitioner through a temporary agency called into existence for this purpose alone. As the court below aptly observed (R. 34), the Averill Corporation was intended to act only as a "conduit" for the transfer of the Monitor shares to the petitioner.

As a general rule a corporation and its stockholders are deemed separate entities, but the rule is subject to the qualification that the separate entity may be disregarded in exceptional situations where it otherwise would present an obstacle to the due protection or enforcement of public or private rights. *New Colonial Ice Co.* v. *Helvering,* 292 U. S. 435, 442. We do not contend that the existence of the Averill Corporation need be disregarded for all purposes. As the court below observed (R. 37), the corporation had a juristic per-

sonality, whatever the purpose of its organization. But we do contend that, looking to the substance of the transaction, it is apparent that the Averill Corporation was a mere device or instrumentality formed and availed of solely to avoid a tax which was clearly intended to be imposed, and that the corporation should be so regarded for the purposes of the tax.

It will be noted that only one interest was involved. All of the stock of both United Mortgage Corporation and Averill Corporation was owned by the petitioner and the acts of these corporations were entirely subject to her dictation. The Averill Corporation was formed solely for a single purpose of the petitioner and was merely her *alter ego*. In such cases the intermediate corporation has frequently been regarded as a mere agency or channel through which to pass the property. *Southern Pacific Co.* v. *Lowe,* 247 U. S. 330; *Gulf Oil Corp.* v. *Lewellyn,* 248 U. S. 71; *Labrot* v. *Burnet,* 57 F. (2d) 413 (App. D. C.); *Hamilton Ridge Lumber Sales Corp.* v. *Wilson,* 25 F. (2d) 592 (C. C. A. 4th). And see *Coudon* v. *Tait,* 56 F. (2d) 208 (Md.), affirmed, 61 F. (2d) 904 (C. C. A. 4th), certiorari denied, 289 U. S. 733. When a corporation so controlled is created or used to avoid or circumvent a statute the substance has been treated as of paramount importance without regard to the effect of the intervening agency. Cf. *United States* v. *Lehigh Valley R. R. Co.,* 220 U. S. 257, 273; *Chicago, M. & St. P. Ry.* v. *Minn. Civic Ass'n.,*

247 U. S. 490. In the latter case the Court said (p. 501):

> While the statements of the law thus relied upon are satisfactory in the connection in which they were used, they have been plainly and repeatedly held not applicable where stock ownership has been resorted to, not for the purpose of participating in the affairs of a corporation in the normal and usual manner, but for the purpose, as in this case, of controlling a subsidiary company so that it may be used as a mere agency or instrumentality of the owning company or companies. *United States* v. *Lehigh Valley R. R. Co.*, 220 U. S. 257, 273, and *United States* v. *Delaware, Lackawanna & Western R. R. Co.*, 238 U. S. 516. In such a case the courts will not permit themselves to be blinded or deceived by mere forms of law but, regardless of fictions, will deal with the substance of the transaction involved as if the corporate agency did not exist and as the justice of the case may require.

We submit that the principle should be applied here since the only purpose of creating the Averill Corporation was to distribute an asset of the United Mortgage Corporation to the petitioner, its sole stockholder, in such manner as to avoid a tax clearly intended to be imposed.

In certain other cases the courts have refused to be blinded by the mere form a transaction was made to take and have rested their decisions on the real purpose and objective of the participants.

In *Hellebush* v. *Commissioner,* 65 F. (2d) 902 (C. C. A. 6th), the stockholders had decided to quit business and liquidate their corporation. A purchaser was found for its properties and the stockholders by resolution authorized the dissolution and liquidation of the company and the conveyance of its assets to certain of its officers as trustees for the stockholders. On the same day the corporate officers transferred the property to the trustees, who then sold to the purchaser. The Board of Tax Appeals and the Circuit Court of Appeals held that this constituted a sale by the corporation itself, giving rise to taxable gain. The court said in part (p. 904):[3]

> The utmost that can be said for this resolution is that it constituted an agreement between the stockholders upon a procedure with which they were themselves contented and through which the Blackburn Company could sell its property. However satisfactory and unobjectionable this arrangement may have been as between themselves [*Chattanooga Savings Bank* v. *Brewer,* 9 F. (2d) 982, 989 (D. C.)], it could not impair the right of the Commissioner to challenge its validity for purposes of taxation. The law will look through forms to substance [*U. S.* v. *Phellis,* 257 U. S. 156, 42 S. Ct. 63, 66 L. Ed. 180; *Board* v. *Comm'r,* 51 F. (2d) 73, 75 (C. C. A. 6)], and will recognize the out-

[3] While a specific regulation covered the situation in that case, the principle is the same here.

> standing fact, that the Cook Company had thereby acquired the property and assets of the Blackburn Company just as was contemplated before the stockholders' meeting on April 20th. We think that this was a sale by one company to the other upon the profits of which the Government was entitled to its taxes.

In *S. A. MacQueen Co.* v. *Commissioner,* 67 F. (2d) 857 (C. C. A. 3d), the three stockholders of a corporation, who were also its directors, adopted a resolution authorizing themselves to sell real estate owned by the corporation to its president, for the sum of $85,000. On the following day the president entered into an agreement with a purchaser to convey the real estate to the latter for $150,000, and executed a declaration of trust in which he recited his intention to distribute the profits proportionately to the stockholders. The transaction was carried out in this manner. In holding that the corporation was taxable on the sale price of $150,000, rather than $85,000, the court said (p. 858):

> The principle that substance and not form should control in the application of income tax laws [*United States* v. *Phellis,* 257 U. S. 156, 42 S. Ct. 63, 66 L. Ed. 180; *Labrot* v. *Burnet,* 61 App. D. C., 47, 57 F. (2d) 413; *Reed* v. *United States* (C. C. A.) 51 F. (2d) 941] may be invoked in the instant case. Although in form there were two sales of the corporate real estate, first, the purported

sale by the petitioner to MacQueen, and, second, the sale by MacQueen to Hatfield, in substance the transaction was a sale by the petitioner to Hatfield through the agency of MacQueen. So also, although in form MacQueen was a trustee for the distribution of the profits earned by the sale of his own real estate to Hatfield, in substance he was the agent of the petitioner for the distribution of the profits from the sale of the corporation's real estate among its stockholders.

The corporate tax rate imposed by the applicable taxing statutes is higher than the individual rate. The obvious purpose of the procedure followed by the petitioner, its directors, and stockholders, was to take advantage of the lower tax rate permitted individuals and thereby avoid the corporate tax rate on the profits of the ultimate sale of the real estate. Such anticipatory arrangements and contracts, intended to circumvent the taxing statutes, are not looked upon with favor. *Lucas* v. *Earl,* 281 U. S. 111, 50 S. Ct. 241, 74 L. Ed. 731; *Phelps* v. *Commissioner* (C. C. A.) 54 F. (2d) 289, certiorari denied, 285 U. S. 558, 52 S. Ct. 458, 76 L. Ed. 946.

The petitioner argues that she did only what the Revenue Act permits. But the Revenue Act taxes such distributions in broad terms. It never was intended to permit avoidance of the tax by means of an agency created, it may be true, to conform to the literal specifications of a statute which had a certain end in view, but created with the sole purpose of avoiding the tax intended to be laid upon

all alike. Applying, as we submit the Court should, the principle that the real substance of the transaction should be the test, it must follow that the Monitor stock was distributed as a dividend to the petitioner from the Averill Corporation as a mere instrumentality and the value of the Monitor stock should be held to be taxable to the petitioner as a dividend.

CONCLUSION

The decision of the court below is correct and should be affirmed.

Respectfully submitted.

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NOVEMBER, 1934.

APPENDIX

STATUTES AND REGULATIONS INVOLVED

Revenue Act of 1928, c. 852, 45 Stat. 791:

SEC. 22. GROSS INCOME.

(a) *General definition.*—"Gross income" includes gains, profits, and income derived * * * from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever.

* * * * *

(d) *Distributions by corporations.*—Distributions by corporations shall be taxable to the shareholders as provided in section 115.

(e) *Determination of gain or loss.*—In the case of a sale or other disposition of property, the gain or loss shall be computed as provided in sections 111, 112, and 113.

* * * * *

SEC. 111. DETERMINATION OF AMOUNT OF GAIN OR LOSS.

(a) *Computation of gain or loss.*—Except as hereinafter provided in this section, the gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the basis provided in section 113, and the loss shall be the excess of such basis over the amount realized.

* * * * *

(c) *Amount realized.*—The amount realized from the sale or other disposition of

property shall be the sum of any money received plus the fair market value of the property (other than money) received.

(d) *Recognition of gain or loss.*—In the case of a sale or exchange, the extent to which the gain or loss determined under this section shall be recognized for the purposes of this title, shall be determined under the provisions of section 112.

* * * * *

SEC. 112. RECOGNITION OF GAIN OR LOSS.

(a) *General rule.*—Upon the sale or exchange of property the entire amount of the gain or loss, determined under section 111, shall be recognized, except as hereinafter provided in this section.

* * * * *

(g) *Distribution of stock on reorganization.*—If there is distributed, in pursuance of a plan of reorganization, to a shareholder in a corporation a party to the reorganization, stock or securities in such corporation or in another corporation a party to the reorganization, without the surrender by such shareholder of stock or securities in such a corporation, no gain to the distributee from the receipt of such stock or securities shall be recognized.

* * * * *

(i) *Definition of reorganization.*—As used in this section and sections 113 and 115—

(1) The term "reorganization" means (A) a merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or substantially all the properties of another corporation), or (B) a transfer by a corporation of all or a part of its assets

to another corporation if immediately after the transfer the transferor or its stockholders or both are in control of the corporation to which the assets are transferred, or (C) a recapitalization, or (D) a mere change in identity, form, or place of organization, however effected.

(2) The term "a party to a reorganization" includes a corporation resulting from a reorganization and includes both corporations in the case of an acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation.

(j) *Definition of control.*—As used in this section the term "control" means the ownership of at least 80 per centum of the voting stock and at least 80 per centum of the total number of shares of all other classes of stock of the corporation.

SEC. 113. BASIS FOR DETERMINING GAIN OR LOSS.

(a) *Property acquired after February 28, 1913.*—The basis for determining the gain or loss from the sale or other disposition of property acquired after February 28, 1913, shall be the cost of such property; except that—

* * * * *

(9) TAX-FREE DISTRIBUTIONS.—If the property consists of stock or securities distributed after December 31, 1923, to a taxpayer in connection with a transaction described in section 112 (g), the basis in the case of the stock in respect of which the distribution was made shall be apportioned, under rules and regulations prescribed by the Commissioner with the approval of the Secretary, between

such stock and the stock or securities distributed;

* * * * *

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) *Definition of dividend.*—The term "dividend" when used in this title (except in section 203 (a) (4) and section 208 (c) (1), relating to insurance companies) means any distribution made by a corporation to its shareholders, whether in money or in other property, out of its earnings or profits accumulated after February 28, 1913.

(b) *Source of distributions.*—For the purposes of this Act every distribution is made out of earnings or profits to the extent thereof, and from the most recently accumulated earning or profits. * * *.

(c) *Distributions in liquidation.*—Amounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock, and amounts distributed in partial liquidation of a corporation shall be treated as in part or full payment in exchange for the stock. The gain or loss to the distributee resulting from such exchange shall be determined under section 111, but shall be recognized only to the extent provided in section 112. * * *.

Treasury Regulations 74 (promulgated under the Revenue Act of 1928):

ART. 576. *Receipt of stock or securities in reorganization.*—If, without any surrender of his stock or securities, a shareholder in a corporation a party to a reorganization receives in pursuance of the plan of reorganization stock or securities in such corporation or in another corporation a party to the reorganization, no gain to the shareholder will be recognized.

ART. 578. *Source of distribution of stock or securities.*—The general rule, provided in section 115 (b), that every distribution is made out of earnings or profits to the extent thereof and from the most recently accumulated earnings or profits, does not apply to a distribution, in pursuance of a plan of reorganization, by or on behalf of a corporation a party to the reorganization, of its stock or securities or of stock or securities in a corporation a party to the reorganization. Such a distribution will not be considered a distribution of earnings or profits in determining the amount of earnings and profits accumulated since February 28, 1913, which are available for distribution and which under section 115 (b) must be distributed before earnings and profits accumulated before March 1, 1913, may be distributed exempt from tax.

* * * * *

ART. 600. *Stock or securities distributed in reorganization.*—In the case of stock or securities acquired by a shareholder after December 31, 1923, in connection with a transaction described in section 112 (g) and article 576, the basis in the case of the stock in respect of which the distribution was made shall be apportioned between such stock and the stock or securities distributed to the shareholder. The basis for the old and new shares shall be determined in accordance with the following rules:

* * * * *

ART. 621. *Dividends.*—The term "dividends" for the purpose of Title I (except when used in sections 203 (a) (4) and 208 (c) (1)) comprises any distribution in the ordinary course of business, even though

extraordinary in amount, made by a domestic or foreign corporation to its shareholders out of its earnings or profits accumulated since February 28, 1913. * * *.

ART. 622. *Source of distribution.*—For the purpose of income taxation every distribution made by a corporation is made out of earnings or profits to the extent thereof and from the most recently accumulated earnings or profits.

ART. 625. *Distributions in liquidation.*—Amounts distributed in complete liquidation of a corporation are to be treated as in full payment in exchange for the stock, and amounts distributed in partial liquidation are to be treated as in part or full payment in exchange for the stock so canceled or redeemed. * * *.

The gain or loss to a shareholder from a distribution in liquidation is to be determined, as provided in section 111 and article 561, by comparing the amount of the distribution with the cost or other basis of the stock provided in section 113 and articles 591–604; but the gain or loss will be recognized only to the extent provided in section 112 and articles 571–580. Any gain to the shareholder may, at his option, be taxed as a capital net gain in the manner and subject to the conditions prescribed in section 101 and articles 501–503. * * *

ART. 627. *Dividends paid in property.*—Dividends paid in securities or other property (other than its own stock) in which the earnings of a corporation have been invested, are income to the recipients to the amount of the market value of such property when receivable by the shareholders. (See, however, section 112 (h) and article 576.) Where a corporation declares a dividend

payable in stock of another corporation, setting aside the stock to be so distributed and notifying the shareholders of its action, the income arising to the recipients of such stock is its market value at the time the dividend becomes payable. * * *.

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